



U.S. SENATE COMMITTEE ON

Finance

SENATOR CHUCK GRASSLEY, OF IOWA - CHAIRMAN

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Grassley Works to End Unfair Taxation in Civil Rights Cases

WASHINGTON – Sen. Chuck Grassley, chairman of the Committee on Finance, is working to end a tax law fluke that forces plaintiffs who win settlements in civil rights cases and other lawsuits to pay income taxes on parts of the settlements they never see – in some cases even owing thousands of dollars more than they win. Several Iowa lawyers have written to Grassley out of concern for their clients in these cases.

“Tax relief gets the headlines, but part of tax relief is tax fairness,” Grassley said. “It’s clearly a fairness issue to make sure people don’t have to pay income taxes on income that was never theirs in the first place. That’s common sense.”

Grassley late last week included a provision in his committee-passed economic growth bill to end the practice of unfair taxation in certain lawsuits. The bipartisan provision Grassley included would, in effect, exclude from a plaintiff’s taxable income legal fees in certain civil rights suits, including those alleging job-related discrimination, and other lawsuits (please see details below).

Under current law, since 1996, plaintiffs who win damages in personal injury cases that involve physical injuries aren’t taxed. But damages in cases involving discrimination on the basis or age, race or sex are taxed.

For example, Cynthia C. Spina, an Illinois police officer, secured a \$1.525 million settlement from her department last year after a long legal battle in which she alleged that she was a victim of sexual discrimination and harassment. But, through a quirk in the law, Spina’s tax bill on the settlement could erase her gains and leave her owing \$100,000 more. That’s because she must pay income tax on the entire settlement, even though the court earmarked \$1.15 million of it for legal fees and costs, according to media reports.

“If we don’t fix this law, it could have a chilling effect on discrimination cases,” Grassley said. “Legitimately wronged people could have little recourse. A out-of-whack tax system is in danger of negating the value of discrimination lawsuits.”

The provision Grassley included will receive full Senate consideration as part of the broader economic growth package this week and could win Senate approval later this week.

A description of the civil rights tax relief provision follows.

Civil Rights Tax Relief

Present Law

Under present law, gross income generally does not include the amount of any damages (other than punitive damages) received (whether by suit or agreement and whether as lump sums or as periodic payments) by individuals on account of personal physical injuries (including death) or physical sickness. Expenses relating to recovering such damages are generally not deductible.

Other damages are generally included in income. The related expenses to recover the damages, including attorneys' fees, are generally deductible as miscellaneous itemized deductions to the extent the taxpayer's total miscellaneous itemized deductions exceed two percent of adjusted gross income. Any amount allowable as a deduction is subject to reduction under the overall limitation of itemized deductions if the taxpayer's adjusted gross income exceeds a threshold amount. For purposes of the alternative minimum tax, no deductions are allowed for any miscellaneous itemized deductions.

In some cases, claimants will engage an attorney to represent them on a contingent fee basis. That is, if the claimant recovers damages, a prearranged percentage of the damages will be paid to the attorney; if no damages are recovered, the attorney is not paid a fee. The proper tax treatment of contingent fee arrangements with attorneys has been litigated in recent years.

Some courts have held that the entire amount of damages is income and that the claimant is entitled to a miscellaneous itemized deduction subject to both the two-percent floor as an expense for the production of income for the portion paid to the attorney and to the overall limitation on itemized deductions that applies above specified income levels. Other courts have held that the portion of the recovery that is paid directly to the attorney is not income to the claimant, holding that the claimant has no claim of right to that portion of the recovery.

Reasons for Change

The Committee recognizes that civil rights laws provide important protections and remedies to victims of unlawful discrimination. The Committee understands that amounts received by individuals on account of claims of unlawful discrimination may include attorneys' fees and costs and that such attorneys' fees and costs may be larger than the actual award. The Committee believes that it is not appropriate for individuals to be subject to tax on the portion of amounts received on account of unlawful discrimination which is attributable to such fees and costs. The Committee also believes that a clear rule for attorney's fees in such cases will provide simplification.

Explanation of Provision

The provision provides an above-the-line deduction for the portion of amounts received by individuals on account of claims of unlawful discrimination which is attributable to attorneys' fees and costs.

Under the provision, “unlawful discrimination” means an act that is unlawful under certain provisions of any of the following: the Civil Rights Act of 1991, the Congressional Accountability Act of 1995, the National Labor Relations Act, the Fair Labor Standards Act of 1938, the Age Discrimination in Employment Act of 1967, the Rehabilitation Act of 1973, the Employee Retirement Security Income Act of 1974, the Education Amendments of 1972, the Employee Polygraph Protection Act of 1988, the Worker Adjustment and Retraining Notification Act, the Family and Medical Leave Act of 1993, chapter 43 of Title 38 of the United States Code, the Revised Statutes, the Civil Rights Act of 1964, the Fair Housing Act, the Americans with Disabilities Act of 1990, the False Claims Act, any provision of Federal law prohibiting the discharge of an employee, discrimination against an employee, or any other form of retaliation or reprisal against an employee for asserting rights or taking other actions permitted under Federal law, or any provision of State or local law, or common law claims permitted under Federal, State, or local law providing for the enforcement of civil rights or regulating any aspect of the employment relationship, including prohibiting the discharge of an employee, discrimination against an employee, or any other form of retaliation or reprisal against an employee for asserting rights or taking other actions permitted by law.

Effective Date

The provision is effective for awards received after the date of enactment.